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"The two most essential conditions for the smooth progress of an expansion are, broadly speaking, an elastic supply of money and an elastic supply of means of production. Both conditions are essential. If either is lacking, the situation becomes precarious."

Gottfried Haberler, Prosperity and Depression, p. 356, 1937

HIGHLIGHTS

Any economic recovery out of a slump must be implicitly preceded and accompanied by a strong monetary expansion through the banking system — the engine of credit and money creation.

What we see today is a letter-perfect replay of what happened in 1930. The Fed may inject reserves, but unless banks expand their loans and investments, the desired and essential monetary expansion fails. For the first time since the 1930s, the U.S. banking system has virtually shut down.

Every cyclical U.S. recovery has been preceded by a stock market surge. However, it is also true that not every stock market surge during the time of recession has been followed by an economic recovery. Markets are anticipating an economic rebound for which the necessary monetary and financial preconditions are grossly missing.

The obsession with consumer confidence has diverted attention from the true deep-seated cause of this U.S. recession: the past massive debt-leveraging of the consumer, corporations and the financial system — all three inter-acting with mutually reinforcing effects.

Since money and credit supply continues to contract in real terms, it's high time to worry about the real threat of a cumulative, self-reinforcing contraction process taking hold, above all in the United States. Inescapably, that would end in crisis and a deep, prolonged recession.

Europe, too, is slowing. The key aspect to emphasize here, though, is that Continental Europe's economies remain in good balance as compared to the grossly imbalanced state of the Anglo-Saxon economies. In terms of underlying fundamentals — capital formation, investment, business profitability and inflation — Europe is in its best shape of the past 20 years.

Considering the rapidly weakening world economy, German unification with its attendant tremendous demand effects and investment requirements could not have come at a better time both for Germany and Europe. It will help to deflect the depressive influences from other parts of the world, above all from the United States.

Despite an expected slowdown in Germany, inflation pressures, though, will be rising. An monetary easing, in any case, is absolutely out of the question for the forseeable future.

WHEN A BOOM IS A BUBBLE

All of a sudden, the world has been smitten by a drastic change in perspective. On the one hand, the perceived outlook for the U.S. economy has turned up red roses while the expectations for Europe and Germany is all spiny thorns. Most pointedly, this perceptual revision of relatives has swept the currency markets. Within barely four weeks, from a state where the U.S. dollar was dropping like a rock towards DM 1.40, it promptly began hurtling like a rocket towards DM 1.70.

Clearly, economic trends don't reverse that fast, only market perceptions and sentiment do. The pushing-power of such an about-turn can put on a tremendous display whether or not the underlying assumptions are right or wrong.

It seems that after about six months of unrelentingly drab news on the U.S. economy, markets were simply athirst for any confirming signs — whether flimsy or not — that the promised economic rebound was just around the corner. Most commentators, including Fed-Chairman Greenspan, were quick to rush out public reports of their sightings of an economic recovery. We wonder a bit whether this latest renaissance of American optimism is nothing more than the return of the old "soft landing" optimism which had been temporarily clobbered by the extremely bearish data of the past months.

Every major market move needs a convincing rationale, especially if it is to gain such a widespread acceptance so quickly. Virtually overnight, it has become the consensus view that a more aggressive Fed easing together with a sharp stock market rally and the Gulf victory could not fail to set the stage for an imminent recovery of the U.S. economy and therefore would soon lead to rising U.S. interest rates.

The perception of a rapidly improving economic outlook for the United States, however, is only one side of the bullish dollar equation. Its flip side is an equally instant consensus change regarding economic growth prospects in Europe, Germany and Japan. All of a sudden, the view that sharply slowing economies would force the central banks in these countries to reverse their tight money policies with the objective of stimulating their own economies with easier money and lower interest rates has gained momentum. As interest rate trends are the main determinant of short term currency movements, this expected reversal in relative interest rate trends made the bull case for the dollar.

CONSUMER CONFIDENCE — THE DEUS EX MACHINA

American economists and politicians are great believers in the key role of consumer confidence and consumer spending in causing cyclical upturns and downturns. It's literally their "*deus ex machina*". When the U.S. economy began its precipitous slide half a year ago, it immediately became accepted doctrine that this was attributable to a war-induced plunge in consumer confidence which, in turn, impelled businesses to batten down the hatches.

As we have often stressed, this whole story is rigmarole. The obvious direct cause of the U.S. recession is a sharp decline in the consumer's real income — the steepest decline of the post-war period. A lack of income has been forcing the consumer to pare spending. Why? Because businesses are slashing employment in response to a liquidity and profitability crisis.

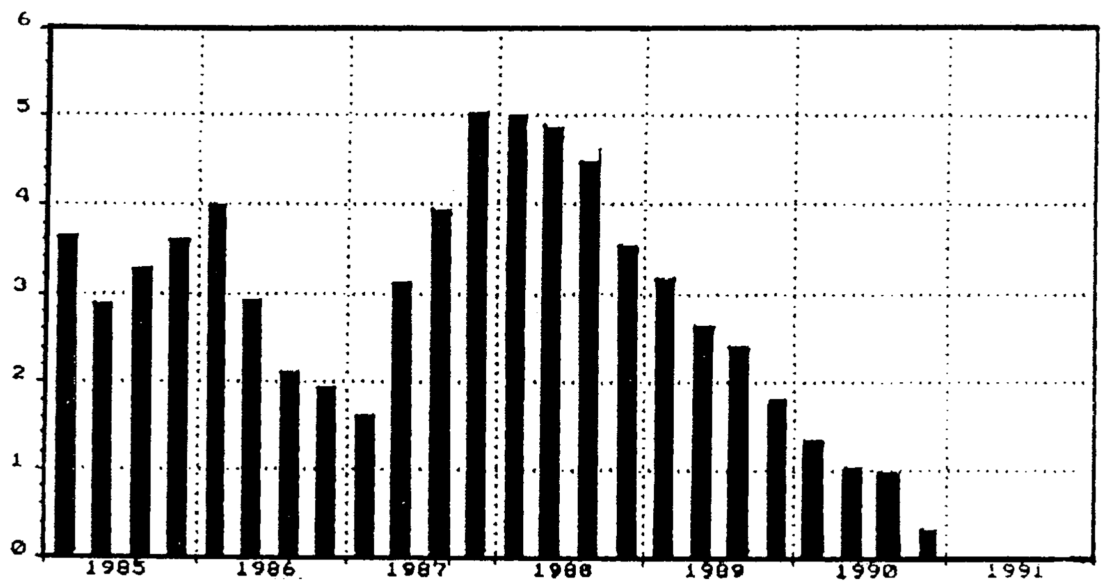
The straight logic of this slavish reverence for the moody consumer is that consumption, after all, is by far the biggest GNP component. What's good for consumption it good for the economy. According to

this same logic, then, it follows that freight trains are propelled by the freight cars and not the locomotive since the wagon train is much larger than the engine. In any case, since the Gulf war supposedly shattered consumer confidence, it seems equally self-evident that the war's victorious end ought to revive the consumer's spirits and willingness to spend and therefore prompt economic recovery.

What on earth is really happening to the U.S. economy and, for that matter, what's the reality of economic conditions in Europe and Germany? Why is it that the same Anglo-Saxon economists who were so blind and unwilling to recognize recessions in their own backyard — even to a point long after unmistakable evidence had arrived with a vengeance — are now so impatient to sight recession in other pastures, above all, in Germany and Continental Europe?

Frankly speaking, it's truly ludicrous how one-sided the economic discussion is in the United States today. It all centres on the one single question of consumer confidence as if it were the single factor driving economies and as if there were no other problems. The truth be known, the current downturn in the U.S. economy started two years ago, well before the outbreak of the Gulf crisis — first slowly, then accelerating into mid-1988. The following chart documents that trend.

U.S. GNP GROWTH (REAL)
(Year-over-year % Change)



Source: Datastream

Nevertheless, forecasters are convinced that a recovery is due shortly. Towards that end, even the flimsiest indications in the monetary and economic data that could possibly be construed as the first sign of an upturn are immediately seized upon as final evidence. Even we, who are deeply concerned about the outlook for the Anglophone countries, realize that statistics don't move in straight lines.

BLIND FAITH IN THE STOCK MARKET

For proof of an impending economic rebound in the U.S., faithful bulls point excitedly at the stock market upturn that started last October and has since gathered momentum into a near-mania early this year. Mr. Geoffrey Moore, leading business cycle expert at Columbia University, went public in confirming that share prices have accurately predicted seven of the eight economic recoveries since 1948.

The Bank Credit Analyst in its recent March issue was even more categoric, stating that "*trends in stock prices forecast trends in profits and the economy*", and not the other way around. Quoting them further: "*Our indicators, based on research on data spanning 70 years are forecasting a sustainable uptrend in stock prices, which in turn have an excellent record of forecasting economic and profit recovery. There are no cases on record in the past 70 years when following the onset of recession, a recovery in stock prices of the October 1990 to February 1991 character gave a false signal. On average, stocks have led the upturn in the economy by a little less than five months if we exclude the pre-World War II period, with a range spanning a lag of one month to a lead of nine months.*"

Obviously, this view has been instantaneously adopted as a worldwide consensus. Interestingly, Salomon Brothers, in a recent brief (Comments on Credit, February 22), came to the opposite conclusion stating that false rallies during a recession have occurred quite frequently over the past 50 years.

Considering the prominence given to the stock market boom as a forerunner of economic recoveries, let's briefly examine the underlying assumptions in that relationship, both in theory and in actual fact.

To start with, one thing is true: Every cyclical U.S. recovery has been preceded by a stock market surge. Probably, that observation applies to most countries. However, it is also true that not every stock market surge during the time of recession has been followed by an economic recovery.

ALWAYS A FIRST TIME: WITNESS 1929-1930

Actually, one major exception to the above rule did occur which the Bank Credit Analyst should not have overlooked. That instance was the stock market boom from mid-November of 1929 to mid-April 1930 which propelled the Dow Jones Industrials Average (DJIA) upward by no less than 50%. What ensued, however, was not the generally expected economic recovery but an unprecedented economic collapse ushering in a deep and protracted depression.

On the economic forecasting front, that depression claimed many casualties. One of them was the famous Harvard ABC Barometer. It was based on the interrelationships of three curves. Curve A reflected mainly stock prices, curve B business activity, and curve C monetary conditions. In the Harvard model, stock prices played a prominent role as an early economic indicator. That emphasis on stock prices was based on the theory that excess money created by the banking system invariably would express itself first in the securities markets, most conspicuously so as a stock market boom.

Unfortunately, 1929-30 proved to be a disastrous exception. Industrial production peaked in June 1929, well before the stock market peaked that September. The final disaster, however, struck in the following year. Earlier, while stock prices rallied strongly — fanned by sharply falling interest rates — businessmen and forecasters were led to expect nothing worse than a mild recession. The press was full of optimistic statements. It seemed as if the stock market crash had gone just as quickly as it had come.

As we all know in retrospect, the short-lived though spectacular stock market recovery of 1930 gave way to the Great Depression. It was only rather late in 1930 when the recovery had unmistakably stalled, that optimistic expectations dissolved. A famous metaphor from Schumpeter describes the prevailing state of mind in late 1930: "*People, for the most part, stood their ground firmly. But that ground itself was about to give way.*"

Based on its scientific barometer, the Harvard Economic Society maintained its optimistic view until early 1931. Neither had it foreseen the economic downturn in 1929 nor the debacle that started in late 1930. That failure dealt the death blow to the ABC curves and the Society. Unfortunately, since today's economists know little of history, the barometer's A curve — stock prices as a leading economic indicator — is back in fashion more than ever before.

WATCH THE BANKING SYSTEM. IT'S THE KEY TO LIQUIDITY

What went wrong in 1929-30? Well, precisely the same thing that is going wrong now. In 1929-30, the U.S. banking system refused to respond to the massive monetary stimulation by the Fed which slashed interest rates and flooded the banks with reserves. Instead of expanding their balance sheets, the banks accumulated reserves in excess of legal requirements. As a result, new credit and money growth disappeared.

Such a credit deadlock has never happened again . . . at least until last year. For the first time since the 1930s, the U.S. banking system has virtually shut down. During the last 4-5 months, literally no new credit has been created through either bank lending or bank investment (bank net purchases of government bonds). That's a picture which is consistent with the persistent anaemia in money growth.

What we see today is a letter-perfect replay of what happened in 1930. The Fed may inject reserves, but unless banks expand their loans and investments, the desired and essential monetary expansion fails. Year-over-year, M2 has now risen 3%, M3 1.7% and M4 2%. In all three cases, that's substantially less than the current inflation rate which hovers between 5-6%, meaning that all three money gauges are sharply down in real terms. Actually, that's worse than in 1930 when the money supply stagnated while price indexes fell. The popularized scapegoat for the Great Depression — the famous collapse of the money supply — did not start until late 1930 and only followed in the wake of the first banking crisis.

The logic behind the theory that a "liquidity-driven" stock market boom is always the precursor of an economic recovery is simple and captivating: In a slow-growth economy where there is only modest demand for funds from the real economy, the "excess liquidity" created by monetary easing must therefore find its way first into financial assets. "Excess liquidity" comes into being when the money supply grows faster than nominal GNP. This model, though, presumes that a rise in stock prices is a virtual mathematical necessity, regardless of valuation levels.

In the actual case, however, there is one snag. The "excess liquidity" that is supposedly driving stock prices higher exists only in the fantasy of Wall Street commentators. In reality, money growth has slowed to record lows for the entire post-war period. By this measure, monetary conditions have never stagnated for such a prolonged period, despite record-high excess reserves.

MONEY SUPPLY AND STOCK PRICES: MYTH AND FACTS

This brings us to the key influence affecting both asset markets and the economy: monetary conditions and monetary expansion. For good reason, we have put a quote from Haberler on the first page stating that an elastic supply of money is indispensable for the progress of an economic recovery. What do the monetary data tell us about the possibility of an impending U.S. economic recovery?

Please, take a look at the chart below. The upper series records the development of bank reserves while the lower series exhibits stock price trends. Both have always moved in perfect lock-step; the causality running from reserves to stock prices. Bull markets, as well as economic recoveries, are always preceded and accompanied by rapidly expanding bank reserves and money supply. Without a doubt, these elements are an indispensable prerequisite.

U.S. BANK RESERVES VERSUS DOW JONES INDUSTRIAL AVERAGE

Total Reserves (Right Scale, $Billions)
Dow Jones Industrial Average (Left Scale)

Reviewing the above chart, after a long steep rise, bank reserve growth turned flat abruptly in 1987 and has stayed flat ever since. During the ensuing four years, money growth has virtually collapsed to rates below the current inflation rate, meaning falling real money supply.

In this last analysis, bank reserves are the broadest proxy for the credit and money creation that are jointly implemented by the central bank and the banking system. Grant's Interest Rate Observer puts it this way: "*The Fed proposes* [by injecting reserves] *and the banks dispose* [by expanding their loans and investments creating new deposits and money against them]."

In December, the Fed moved from a gradual to an aggressive easing, boosting excess reserves to levels never seen before in the post-war period. So far, there is no sign that banks are putting these reserves

to work by either lending or investing (see the March issue of *Currencies and Credit Markets* for documentation on this point). In sum, taking compounding interest rates into account, new bank credit is contracting.

There's more to the story. While the commercial banks have virtually shut down, the S&L's (Savings and Loans) have been suffering massive withdrawals since May 1988. During the last two years, deposit losses of the S&L's have amounted to $204.6 billion — $78 billion in 1989 and $126 billion in 1990. To meet these huge withdrawal demands, S&L's have had to sell assets — both financial and real estate — thus depressing their prices.

How do monetary developments so far compare with past recovery periods? In 1982, a year of deep recession and the starting point of the Reagan stock market boom, total bank loans and investments rose $85 billion or 6.7%. During 1983, when the boom gathered steam, the expansion of bank assets accelerated to $155 billion or 12% and in 1984 by $184 billion or 11%. Since last August, by contrast, bank loans and investments have expanded by a total of 1.4% (annualized), which, we emphasize again, do not encompass the drastic S&L contraction.

We repeat our salient point: Any economic recovery out of a slump must be implicitly preceded and accompanied by a strong monetary expansion through the banking system — the engine of credit and money creation. If the necessary money growth fails to materialize, either prices and/or output have to fall.

SECURITY PRICES VERSUS SECURITY ISSUES

Sufficient credit and money creation by the banks is the one indispensable condition for an economic recovery from a slump. A second indispensable condition is the reliquefication of the business sector. That process operates through another monetary mechanism: namely, stock and bond markets. Typically, American business reliquefies during the recession by launching a heavy volume of new stock and bond issues, as easy money and booming securities markets offer a favourable financing window.

As we observed before, economists like to emphasize that rising stock prices have proven to be a highly reliable forerunner of economic upturns. That, indeed, has been the general experience, yet, they mistake appearance for substance. What really counts in the operation of this mechanism is not the rising securities prices as such, but the rising volume of securities issues. It is through the latter that businesses reliquefy themselves during booming markets. It isn't the wealth effects of buoyant securities markets for the consumer, but the improvement in business liquidity that is the key condition for recovery.

After the past debt orgies of the 1980s, U.S. corporations certainly need reliquefication more urgently than ever before. Figures available for year-end 1990 show the opposite trend: still deteriorating liquidity. Internally generated funds have declined sharply from $403.8 billion in 1988 to less than $350 billion in 1990. At the same time, the net inflow of capital through security issues has steadily declined from $124.7 billion in 1986 to around $50 billion in 1987 and 1988 and $35 billion each in 1989 and 1990. We would say that's not the kind of reliquefication that precedes sustainable economic recoveries.

THE VICIOUS SPIRAL OF SELF-DEFLATION

Concluding our short review of the U.S., we must stress one point: The markets are anticipating an

economic rebound for which the necessary monetary and financial preconditions are grossly missing. Actually, if fact, these conditions are worsening.

The obsession with consumer confidence has diverted attention from the true deep-seated cause of this U.S. recession: the past massive debt-leveraging of the consumer, corporations and the financial system — all three inter-acting with mutually reinforcing effects. In the past, the leveraging effects pulled each other up, now the deleveraging effects pull each other down.

Consumer leverage really amounts to borrowing and spending future income against rising indebtedness. Corporate leveraging amounted to the creation of immense paper profits and paper wealth for stock holders against soaring corporate indebtedness as well as causing a most rapid destruction of Corporate America's capital base. The combined results, as we've often stressed before, were overconsumption, underinvestment, overindebtedness, illiquid consumers and corporations, a real estate crisis and a banking crisis.

Inevitably, such leveraging cannot go on indefinitely. There is bound to come a point where the illiquid and over-indebted participants have to retrench and initiate measures to raise their liquidity again by cutting spending and selling assets. At that point, the entire financial machinery works in reverse with depressing effects on asset prices, incomes and the economy.

The dilemma that arises, then, when everybody tries to get more liquid, is that it tends to set in motion a vicious spiral of mutual self-deflation within which everybody's efforts to improve liquidity backfires into spreading illiquidity further. Just that is happening in the United States and is the obvious root cause of the unfolding recession. Consumers and corporations slashed their new borrowing in the fourth quarter of 1990 to an annual rate of 2.9%. That compares with 7.5% in 1989 and 9.5% in 1988. In real terms, it's a drastic contraction. As incomes and cash flow shrink and asset values fall, overall liquidity continues to deteriorate. The only one thing that could possibly break this vicious spiral is an expanding banking system that creates new money against rising lending and investments. So far, ominously, that's not happening.

As we said before, there is only one precedent for such an experience in living memory. That's the credit deflation of the 1930s.

DESPITE SLOWER GROWTH, EUROPE IS IN GOOD SHAPE

While forecasters and market participants are desperately searching for evidence that the U.S. economy is beginning to recover, they seem to be just as fervently trying to discover economic weakness outside the United States, above all, in Europe.

Throughout the post-war period, cyclical swings in Europe and Japan have, in fact, closely tracked the economic cycle in the United States with only a short lag. This experience prompted the adage "*when America sneezes, the rest of the world catches a cold.*"

What this cyclical pattern reflected, however, was mainly monetary interdependence under a system of fixed exchange rates, not trade dependence. In the 1960s, only 8% of the total exports of the present European Community countries went to the United States. Today, it's even less: 5.9% or barely 1% of European GNP. The fact is that the importance of the United States — both as a trading partner and as

an investment market — is grossly overestimated. One of the ironies is that the most profitable parts of U.S. industry are its European affiliates and the most unprofitable parts of European industry are affiliates in America.

After several years of strong economic expansion, most European economies are faltering. This slowdown, in fact, started well before the Gulf crisis. But recently, growth rates have decelerated to the lower end of 1-2%.

Recessions are nothing new. Economies have always moved in cycles and as long as recessions are mild and orderly, they're no cause for serious worry.

What, then, are the chances for a mild recession in Europe? Every recession must be conceived as a period in which the economy re-adjusts from the excesses, imbalances and distortions that were caused by the prior inflationary boom. Accordingly, the length and severity of a recession depends largely on the magnitude of the prior real and financial maladjustments.

It is the realization of this rule that makes us far more optimistic about the economic outlook for Europe than that for America and the other Anglo-Saxon countries. Their economic and financial equilibrium in the past years has been disrupted as never before. Excessive borrowing, overspeculation, overconsumption, underinvestment and undersaving have played havoc with their economic and financial structures.

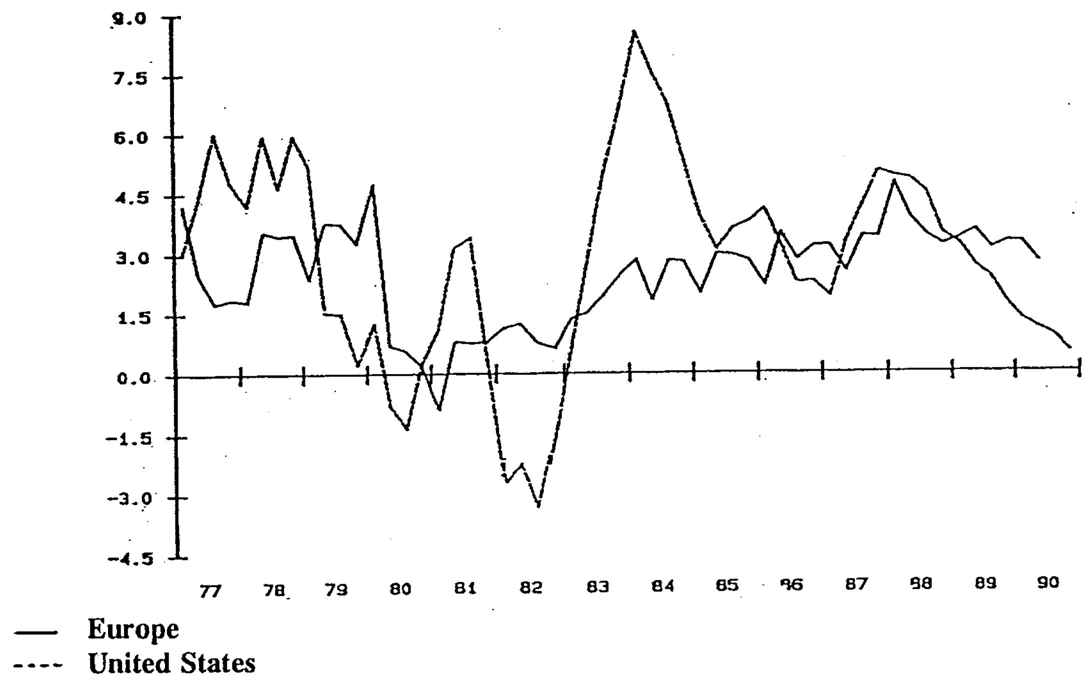
In this respect, Europe and the Anglo-Saxon countries stand diametrically opposite. Continental Europe has enjoyed an unusually long period of well-balanced and healthy growth showing striking improvements in capital formation, investment, profitability and inflation. In a recent economic report, the European Commission wrote: "*One has to go back more than two decades to find in Europe a combination of output growth and low recorded inflation as desirable as today.*"

Slower growth in Europe has been expected. Already in a report published in December, the European Commission stated that the outlook was for further deceleration of growth and employment and accelerating consumer price inflation. The two obvious main influences are the deepening Anglo-Saxon recession and restrictive monetary policies in Europe.

In Europe, though, there is one exception from the trend of a general economic weakening: Germany. Since 1983, the German economy has enjoyed an unbroken period of investment and export-led growth. Lately, weakening exports have been more than supplanted by strong demand from East Germany — that being financed by huge income and capital transfers from the West.

What is a realistic perspective of Europe's economic prospects relative to that of the United States? The key fundamental aspect to emphasize again in answering this question is the relatively well-balanced state of Continental Europe's economies as compared with the grossly imbalanced state of the Anglo-Saxon economies. The key point is that in terms of underlying fundamentals — capital formation, investment, business profitability and inflation — Europe is in its best shape of the past 20 years. As well, financial and banking problems, so rampant in the Anglo-Saxon countries, are non-existent. All this speaks for a normal and limited cyclical weakening. In addition, German unification, with its massive demand effects, lends substantial support to the European economy as a whole.

GNP GROWTH: EUROPE VERSUS UNITED STATES
(Year-over-year % Change)



Source: SMH Research

The reasons for serious worry about the world economy lie outside of Europe. Their origin are generally found in the Anglo-Saxon countries and in America in particular.

RECENT DEVELOPMENTS IN GERMANY

A recent quote from the Wall Street Journal captures the recent mood: "*Through a series of apocalyptic statements about eastern Germany plus several policy mix-ups, German policy makers seem in a conspiracy to weaken the best weapon in their economic arsenal: the mark.*"

No sooner did certain statements surface, than did traders and the media have their story: a rift between Bonn and Bundesbank and therefore an implied signal from the finance minister that Germany would not defend its currency.

Sounds familiar, we thought. It's nothing more than a rehash of the story which had upset foreign investors all through last year: namely, that Mr. Kohl will force the Bundesbank to finance German unification by inflation.

Last year's speculations were sheer fantasy and so are the new ones. There is no rift between Bonn and the Bundesbank. Once again, careless words have been blown up out of proportion.

What's obvious, unfortunately, is that many people have great difficulty in viewing the unification problem from the proper perspective and in its true proportion. To be sure, economic transition in East

Germany is proving more difficult and more expensive than expected. But, this revision of expectations is only one of gradual degree. An economic collapse and unemployment numbering in the millions had been expected right from the start. After all, dismantling must come before rebuilding.

To gain a perspective on the unification issue, three considerations are important: First, the West German economy is ten times the size of East Germany's; second, the West German economy has gained tremendous strength during the past years; and third, the huge capital needs for the rebuilding of East Germany can be easily met from current domestic savings.

Another important perspective is found by comparison: the overall government budget deficit projected for Germany in 1991 corresponds to 4.5% of GNP and about 65% of available domestic personal savings. The U.S. budget deficit, on the other hand, is equivalent to 5% of GNP and 200% of domestic personal savings.

Nevertheless, markets recently have become obsessed with the notion that the U.S. economy will recover while the German economy weakens. We can't help but think that this view stems from confusing absolutes with relatives. To start with, in terms of GNP growth, 1990 was the best year since 1976 for the German economy. In some ways it was probably its best year ever. Real GNP grew 5%, supplying 800,000 new jobs and yet retaining an inflation rate of below 3%. To repeat that kind of performance is next to impossible. Every boom has its limits. Capacity utilization running at peak levels puts on the brakes from the supply side and fiscal and monetary restraint now reins in growth from the demand side. Economic forecasts for 1991 call for GNP growth ranging between 2% and 2.5%, a respectable pace, and one which undoubtedly will be well above U.S. economic growth. By comparison, U.S. growth last year was only 0.5% last year and registered a miserable loss of 1.6 million jobs since mid-1990.

Despite an expected slowdown in Germany, inflation pressures, though, will be rising. The main concern is that a combination of wage raises of around 7%, lower productivity growth and higher consumer taxes will add almost 1% to the consumer price index. Under such conditions, it seems realistic to envisage an inflation rate in the upper 3-4% range for the second half of 1991. Such a trend would surely provoke further monetary tightening by the Bundesbank. An easing, in any case, is absolutely out of the question.

So far, government spending on unification is mainly on income support. Yet, we have no doubt that at some point a tremendous investment boom will get under way in East Germany. Overall, the investment needs for infra-structure, commercial and residential building and industry are simply astronomical.

Implementing and financing German unification is both a vast and complex task. To do justice to the intricacy of the potential problems would require an extensive report much beyond the limits of this letter. Instead, with this issue we have enclosed a paper on that topic that we wrote for a German investment bank earlier this year.

CONCLUSIONS

Considering the rapidly weakening world economy, German unification with its attendant tremendous demand effects and almost unlimited investment needs could not have come at a better time both for Germany and Europe. It will help to deflect the depressive influences from other parts of the world.

above all from America.

With the catalyst of a Gulf victory, euphoria has taken over again in America and its environs. All this bullishness stems from a fanciful perception of an impending U.S. recovery for which there is absolutely no basis in the underlying monetary and financial conditions.

The U.S. recession is much deeper than the consensus realizes. Import inflation has been playing tricks with the trade balance and the conventional GNP figures. Paradoxically, the oil price explosion during the Gulf crisis had the arithmetic effect of sharply improving net exports and GNP. (For an illuminating explanation see the March letter.) As the Commerce Department explained in its latest Survey of Current Business (page 2), without these statistical distortions, real GNP growth would have been 0.2% (instead of 1.4%) in the third quarter and minus 4.5% (instead of minus 1.6%) in the fourth quarter. That phenomenon presages shocking numbers for the first quarter.

These extremely weak "corrected" GNP figures correspond with the rapid downturn in the banking system's money and credit supply. It may well be argued that the Fed will yet pull it off after having eased more aggressively. So far, however, the aggregate banking figures do not reveal any trace of an effective monetary stimulation that would need to precede any upswing.

Instead, what we see in the banking systems balance sheet is the beginning of a cumulative, self-reinforcing contraction process taking hold. Inescapably, that would end in crisis and a deep, prolonged recession.

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